

Aspects of Financial Planning

Employee share schemes

July 2010

Employee share schemes can be an attractive form of remuneration available to employees, however you should be aware of certain restrictions and the risks associated with such an investment. There are also tax implications arising from such plans.

Background

As a supplement to remuneration packages, it is becoming increasingly common for employers to offer to their employees, shares or options to purchase shares in the company. This is referred to as an employee share scheme (ESS).

ESSs are introduced for a variety of reasons. One reason is to align employee and employer interests in order to motivate and retain valued employees.

ESSs can take many forms however two common types are:

- Fully paid plans; and
- Options or rights plans.

Fully paid plans exist where fully paid shares are bought on market, issued and paid for by loans from the company to the individual employee participant, funded out of a share of profits or through salary sacrifice arrangements. Deferred plans, exempt plans, loan plans and salary sacrifice plans all fall into this category.

Options plans exist where employees are given a contractual right, by receiving an option, to acquire a share in the company at a set price in the future. Fully paid shares are issued on 'exercise' of the option, the payment of any specified exercise price and the fulfilment of any other specified conditions. (Please note: options are also termed 'rights'.)





Generally, shares or options are offered by employers in one of the following ways:

- In addition to your salary (ie. incentive offers) – possibly linked to your individual performance, time served or the performance of the business
- In lieu of salary (ie. salary sacrifice offers)
- As part of your remuneration arrangement or as a trade off against other benefits under an Enterprise Bargaining Agreement or individual contract; and
- Through a loan plan where employees buy shares through a loan scheme run by their employer. Often shares are offered at a discounted price, with interest free loans and downside risk protection.

Each ESS is unique. Some businesses run a number of employee share plans that are aimed at different groups of employees. You will need to contact the appropriate person in your business to find out what is offered to you. In addition, before participating, it is important you understand the terms and conditions of the ESS.

Why should you participate?

It is up to you to decide whether or not you participate in an ESS offered by your employer. An ESS can be an attractive method of remuneration for a number of reasons including:

- Acquiring shares in a company means you effectively become part owner of the business
- Employees can share in the success of the company and achieve greater job satisfaction as you will receive concrete rewards for performance through receipt of dividends and capital appreciation
- As a shareholder, you may acquire a voice and/or voting rights and may have increased flexibility and choice when negotiating workplace arrangements
- Acquiring shares at a discount to the market value; and
- Accessing concessional tax arrangements.

Before accepting an offer to participate in an ESS, there are a number of important restrictions, risks and tax implications that need to be considered. To some degree these should be detailed in the offer document, however it is prudent to seek qualified professional advice.





Restrictions and risks

There may be a number of restrictions and triggering events attached to the share offer, including the following:

Vesting restrictions

Some employee share schemes provide employees with the opportunity to receive shares at a discounted, or nil cost. However the scheme may be subject to restrictions to prevent the employee from immediately selling or otherwise dealing in the shares. This is referred to as a vesting restriction. Once your shares have vested, there may be a process for you to follow in order to access them. This may involve lodging a form with the administrator of the ESS.

Ceasing employment

There may be additional conditions that are triggered at the time you cease to be an employee of the company. For example, it may be a condition of the plan that the shares are sold at this point, or you may have to repay monies in order to access the shares. There may be performance criteria or implications if you are dismissed as a result of misconduct.

Company restructure

In some cases your shares may be sold or withdrawn from the ESS and a tax event triggered if the company is sold or restructured. You need to be clear from the outset as to what happens with your shares/options if the business is sold or restructured and you continue on as an employee in the new business.

Tax implications

There are tax implications to acquiring shares, even if the shares are given to you as a bonus or incentive. The tax implications depend on the terms and conditions of the plan you are participating in and you should seek appropriate advice about the implications of your participation. (We have provided a brief outline of general tax principles below.)

Participating in an ESS should be seen as making an investment and thus a number of risks should be appreciated including:

Fall in share price

There are risks involved in investing in shares. For example, it is possible for the share price to fall. In the event that you sell your shares below the market value on issue, you are not entitled to a refund of the up-front tax that was paid. You would also crystallise a capital loss, which may be carried forward and used to offset future capital gains. If the shares are retained, then it would be possible to ride out the fluctuations in the value and sell at a better time. The worse





case scenario of course is that you might lose your entire investment in the shares. This is an important consideration if you are thinking of taking part in a plan that involves an employee loan to purchase shares, or sacrificing salary to receive shares, irrespective of any discount or matching offer inducements.

Lack of diversification

Where an employee acquires a large holding of shares through an ESS it can result in a significant portion of their wealth being tied up in the one company. This can present a lack of diversification. Often with smaller, less traded or non-listed companies, problems may also arise when trying to use the shares as security as many lenders may not accept that stock as security. It is important to weigh up the benefit of acquiring the share with the potential that you may not be able to diversify your portfolio.

Taxation implications

Any ESS benefit received will have taxation implications to consider. Those wishing to participate in an ESS should receive a member booklet which should set out the income tax consequences of the scheme and explain the different options available to employees. As personal circumstances impact on taxation and this is a complex area of tax law, it is essential to consult a qualified tax adviser.

ESSs are normally subject to taxation under both the income tax and capital gains tax (CGT) provisions. Shares under an ESS are acquired by the employee at a discount to the market value of the shares. Income tax is applied to the difference between the amount paid for the shares and the market value of the shares over the five trading days prior to the issue of the shares (ie. the 'discount'). Apart from limited circumstances, CGT is payable at the time when the shares are sold.

Upfront taxation

The taxation of ESSs has changed from 1 July 2009 to ensure that any discount to the market value of shares or options acquired under an ESS is generally taxed upfront.

The main conditions to be considered for the upfront concession are:

- The employee must be employed by the company offering the scheme, or one of its subsidiaries
- The ESS interests offered under the scheme must relate to ordinary shares
- The scheme must be offered in a non-discriminatory way to at least 75% of Australian resident permanent employees with three or more years service





- The shares or options provided must not be at real risk of forfeiture
- The shares or rights must be required to be held by the employee for three years or until the employee ceases employment; and
- The employee must not receive more than 5% ownership of the company, or control more than 5% of the voting rights in the company, as a result of participating in the scheme.

This means that in the majority of cases, upfront taxation will apply unless the conditions for deferral are satisfied (discussed below).

Income tax consequences

Under upfront taxation, the employee includes the market value of the discount in their assessable income in the year they receive the shares or options. Employees participating in an ESS who pay tax upfront may be eligible to receive a \$1,000 tax exemption, if they have an adjusted taxable income, after adjustments, less than \$180,000 and the employee and the scheme meet certain conditions. Any discount received in excess of this amount will be assessable.

In regards to acquiring options, an employee includes the amount of the discount received on purchasing the options, in their assessable income in the year they acquire the options. Employees receiving options may also be eligible for the \$1,000 tax exemption.

CGT consequences

Under the CGT provisions, any change in the value of the shares from the date of purchase to the date that the shares are sold will be assessable. For this purpose, the cost base of the share will be the market value of the share at the date that the shares were acquired. Where the shares are held for more than 12 months prior to sale, the 50% individual discount exemption may apply.

In the case of unlisted shares, the ATO has provided a form to be used so that the arms-length value of the shares can be determined by a registered company auditor.

In the case of options, any change in the value of the options from the date of purchase to the date the subsequent shares are sold will be assessable. For this purpose, the CGT cost base used is the market value of the options at the date they are granted plus the amount payable to exercise the options. The 50% discount may also apply if the shares are held for more than 12 months after the date of exercising the options.

Where the options are unlisted, the discount is determined by a formula which looks at:





- The market value of the shares when the rights are acquired
- The amount payable to exercise the rights; and
- The maximum period of time to exercise the rights.

Strategy implications

Using upfront taxation, less is taxed as ordinary income and more is taxed as capital gain, which may also potentially be subject to the 50% discount.

Generally speaking, if the shares are held for longer than 12 months after the taxing point and there is strong growth in the share price between the acquisition date and the taxing point, upfront taxation will produce a good overall tax result.

If an employee's shares and options are subsequently forfeited, the employee will generally be entitled to a refund of the tax previously paid. This is the case if the forfeiture was not the result of a choice of the employee, except a choice to leave employment, or a condition of the scheme that protects that employee against a fall in market value.

Up-front taxation example

On 1 July 2009, Kym acquires 1,000 shares in her employer's company for \$8 per share. The shares must be held by Kym for three years (until 1 July 2012), or until Kym ceases employment. The average market value of the shares in the five trading days prior to 1 July 2009 is \$10 per share.

Kym sells her shares on 1 July 2013 for \$25 per share.

Assuming Kym is subject to tax at the highest marginal tax rate (45% + 1.5% Medicare levy), taxation will be determined on an upfront basis. This has implications for both her income tax and CGT liabilities as outlined below.

Upfront income tax payable in the 2010/11 financial year:

Market value of shares on acquisition (1,000 @ \$10)	\$10,000
Amount paid for shares (1,000 @ \$8)	<u>\$8,000</u>
Discount to market value (1,000 x \$2)	\$2,000
Less reduction amount	<u>(\$1,000)</u>





Amount included in assessable income	<u>\$1,000</u>
Tax payable = (\$1,000 x 46.5%)	\$465

For CGT purposes, the cost base of the shares is \$10 per share. The 50% CGT discount will apply as the shares have been held for more than 12 months, therefore the CGT liability under upfront taxation is:

Capital gains tax payable in the 2013/14 financial year:

$$\text{Tax payable} = 1,000 \text{ shares} \times (\$25 - \$10) \times 0.5 \times 46.5\% = \$3,487.50$$

Deferred taxation

From 1 July 2009, tax on the discount for securities granted under an ESS will be paid upfront unless the conditions for deferral are satisfied. Whether a share or option is subject to deferred taxation depends on the structure of the scheme and not an election by the employee.

The deferral of tax will be limited to the following two conditions:

- The relevant ESS interests must be acquired at a discount under an ESS, relate to ordinary shares and be subject to a 'real risk of forfeiture' (explained below); and
- The relevant ESS interests must be acquired under a salary sacrifice arrangement and the employee must receive no more than \$5,000 worth of shares under those arrangements in an income year. Please note that the employee must meet certain other conditions.

Real risk of forfeiture

Real risk of forfeiture is defined as a circumstance in which there is a real risk that the employee may forfeit or lose the ESS interest, other than by intentionally taking no action to realise the benefit. Real risks of forfeiture in a scheme may include conditions where retention of the ESS interests is subject to performance hurdles or a minimum term of employment.

There is no real risk of forfeiture where a scheme simply includes a condition which:

- Restricts an employee from disposing of an ESS interest for a specified time
- Allows an employee to request that the ESS interest be forfeited; or
- Provides for an employee to forfeit an ESS interest if they are dismissed for fraud or gross misconduct.





Income tax consequences

Deferred taxation means any income tax liability is deferred until the taxing point (previously referred to as the cessation time). Under deferred taxation, any growth in the market value of the shares from the date of acquisition up to the taxing point will be taxed as ordinary income.

In regards to acquiring options, taxation is also deferred until the taxing point. This will normally be the time at which the options are exercised, unless there is a further restriction on the sale of the shares. The amount to be included as assessable income is the difference between the market value of the shares at the taxing point less the amount payable to exercise the options less any amount paid to acquire the options.

CGT consequences

Under deferred taxation, CGT is payable on the difference between the market value of the shares at the taxing point and the sale price of the shares. The 50% discount may also apply.

From 1 July 2009, the actual taxing point for securities that qualify for deferred taxation will be the earlier of the following times:

- Shares – where there is no longer a real risk of losing the share and no restriction, at acquisition time, on disposing the share;
- Options – the test is the same as that for shares but is modified where the shares are acquired as a result of exercising a right and those shares are subject to forfeiture and disposal restrictions. Where this is the case, the taxing point is where there is no longer a real risk of losing the share and no restriction, at acquisition time, on disposing of the share which was acquired by exercising the original option; or
- The date at which the owner of the shares or options leaves the employer (cessation of employment); or
- Seven years after the employee acquired the share or option.

Strategy implications

With deferred taxation, more is taxed as income (on a deferred basis) and less is taxed as capital gain. Generally speaking, if the employee does not plan to hold the shares for at least 12 months after the taxing point then deferred taxation will produce a better overall tax result (assuming the conditions of deferral are satisfied).





Employer reporting and tax withholding obligations

The ESS rules from 1 July 2009 mean that employers are subject to additional ESS reporting requirements. The new rules require employers to report the provision of shares or options to the Australian Taxation Office (ATO) and their employees under an annual reporting regime.

Employers will also be required to notify the ATO and their employees of their estimate of the market value of shares or options in any year in which the deferred taxing point occurs.

For the purposes of the new law, the term market value takes on its ordinary meaning. The increased flexibility that this provides means that employees are able to choose a valuation methodology that fits their circumstances. However, there are a number of methods for valuing ESSs that are not publically listed on a stock exchange. These rights are known as “unlisted rights”. An employee can generally choose to value unlisted rights at either:

- The market value according to its ordinary meaning; or
- The amount determined by application of the regulations (under Division 83A of the *Income Tax Assessment Regulations 1997*).

Employers will therefore need to monitor the conditions attaching to the schemes, the exercise of options by employees and other events, such as cessation of group employment, to ensure that they comply with these reporting obligations on a continuing basis.

ESSs will be subject to PAYG withholding tax where no employee Tax File Number is provided.





Centric Wealth Advisers Ltd may be able to be of assistance

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